

# Inspector General

United States  
Department of Defense



Defense Finance and Accounting Service Contract for  
Military Retired and Annuitant Pay Functions

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## Acronyms and Abbreviations

ACS	Affiliated Computer Services
CGA	Continuing Government Activity
CNA	Center for Naval Analyses
DFAS	Defense Finance and Accounting Service
DVA	Department of Veterans Affairs
IG	Inspector General
OIG	Office of the Inspector General
OMB	Office of Management and Budget



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

October 22, 2009

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING  
SERVICE

SUBJECT: Defense Finance and Accounting Service Contract for Military Retired and  
Annuitant Pay Functions (Report No. D-2010-003)

We are providing this report for review and comment. The audit was requested by Congressman Dennis J. Kucinich. We considered management comments on a draft report when preparing the final report.

DOD Directive 7650.3 requires that all recommendations be resolved promptly. The comments from the Defense Finance and Accounting Service were only partially responsive. Therefore, we request additional comments on Recommendations 1.b and 1.c by November 23, 2009.

Please provide comments that conform to the requirements of DOD Directive 7650.3. If possible, please send a .pdf file containing your comments to [audacm@dodig.mil](mailto:audacm@dodig.mil). Copies of the management comments must contain the actual signature of the authorizing official. We are unable to accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 604-9201 (DSN 664-9201).

A handwritten signature in black ink, reading "Richard B. Jolliffe", is positioned above the printed name.

Richard B. Jolliffe  
Assistant Inspector General  
Acquisition and Contract Management





## Results in Brief: Defense Finance and Accounting Service Contract for Military Retired and Annuitant Pay Functions

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### What We Did

At the request of Congressman Dennis J. Kucinich, we reviewed the Defense Finance and Accounting Service (DFAS) contract for military retired and annuitant pay functions. Specifically, we reviewed contractor performance, costs, and staffing, as well as the Government's management of the contract. We also performed a limited review of policies and procedures for voucher prepayment examination.

### What We Found

The DFAS Continuing Government Activity (CGA) did not adequately monitor contractor performance for six of the seven critical performance standards on its \$346 million (10-year) services contract with Lockheed Martin for the military retired and annuitant pay functions. DFAS also did not collect \$547,236 in deductions for unsatisfactory performance.

The call center for military retired and annuitant pay functions operated by Lockheed Martin was providing service to DFAS callers that is far below industry standards. For 2008, the call center monthly average call abandonment rates ranged from 11.0 to 40.6 percent compared to an industry standard of 4.0 percent. In addition, time to answer calls ranged from 108 to 280 seconds compared to an industry standard of 26 seconds.

In September 2006, Department of Veterans Affairs (DVA) identified more than 133,000 recipients of Combat-Related Special Compensation or Concurrent Retired Disability Payment potentially eligible for additional retroactive compensation. The DFAS CGA did not have any standard procedures to conduct pre-payment reviews of DVA retroactive payrolls until March 20, 2009, and Lockheed Martin had updated its review procedures several times increasing the likelihood of payment errors. In addition, DFAS staff supplemented the Lockheed Martin DVA retroactive call center at a cost of \$168,021, so contractor staff could be reassigned to process retroactive payrolls.

### What We Recommend and DFAS Actions Taken During The Audit

We recommend that the Director, DFAS, review the performance of the contracting officers and the objectivity of the CGA Director and exhaust contract remedies to pursue a refund of \$547,236 for performance deductions not taken during the course of the contract. We also recommend that the Director seek reimbursement of the \$168,021 spent supplementing the Lockheed Martin call center.

On December 22, 2008, DFAS completed a business case analysis to evaluate future sourcing options for the military retired and annuitant pay functions. On April 20, 2009, DFAS announced that in early 2010, DFAS would transition the military retired and annuitant pay functions to a Government operation performed by DOD civilians. The business case analysis showed that having DOD civilians perform the work would result in more than \$20 million in funds put to better use over the next 10 years, provide improved flexibility, and reduce risks to operations.

### Management Comments and Our Response

The Director, DFAS Cleveland, disagreed with all three recommendations. However, the response for one recommendation met the intent. The Director stated that DFAS does not have a bi-lateral agreement with the contractor on the performance standards, and therefore, is not entitled to deductions. We disagree with the Director's conclusion because both the contracting officer and the contractor signed the modification implementing new performance standards. In addition, the Director stated that DFAS was offered a reimbursement for supplementing the Lockheed Martin center, but, DFAS did not provide documentation to support the reimbursement. We request that the Director, DFAS, provide additional comments in response to this report. Please see the recommendations table on the back of this page.

## Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Director, Defense Finance and Accounting Service	1.b. and 1.c.	1.a.

**Please provide comments by November 23, 2009.**

# Table of Contents

<b>Results in Brief</b>	i
<b>Introduction</b>	1
Objectives	1
Contract History and Prior Issues	1
Defense Finance and Accounting Service Actions Taken During The Audit	5
Review of Internal Controls	5
<b>Audit Results</b>	6
Recommendations, Management Comments, and Our Response	13
<b>Appendices</b>	
A. Scope and Methodology	16
Prior Coverage	17
B. Congressional Request	18
<b>Management Comments</b>	
Defense Finance and Accounting Service	20

# Introduction

## Objectives

The overall objective of the audit was to review the Defense Finance and Accounting Service (DFAS) contract for military retired and annuitant pay functions. Specifically, we reviewed contractor performance, costs, and staffing, as well as the Government's management of the contract. We also performed a limited review of policies and procedures for voucher prepayment examination. See the Appendix A for a discussion of scope and methodology and prior audit coverage.

## Contract History and Prior Issues

### **Public-Private Competition for the Military Retired and Annuitant Pay Functions.**

In December 1997, DFAS announced the decision to perform a cost comparison of the military retired and annuitant pay functions. The cost comparison is a public-private competition process required by the Office of Management and Budget (OMB) Circular No. A-76 "Performance of Commercial Activities" to compare the cost of Government performance with contract performance. The cost comparison included about 650 positions at 2 DFAS locations, about 500 positions at DFAS Cleveland, and about 150 positions at DFAS Denver. These 2 locations processed payments totaling about \$2.6 billion per month for 2.5 million military retirees and annuitants.

On April 15, 1999, DFAS issued a solicitation requesting private sector proposals for performance of the military retired and annuitant pay functions for a 5-year period. However, in August of the same year, DFAS cancelled the solicitation due to management concerns that the performance work statement was not performance-based and industry concerns on complexity. On September 11, 2000, DFAS issued another solicitation requesting proposals for performance of the military retired and annuitant pay functions for a 10-year period. One contractor, Affiliated Computer Services (ACS), Government Services Inc. submitted a proposal to the solicitation. The contracting officer determined that the contractor's proposal was acceptable and responsive to the requirements of the solicitation. The contracting officer then compared the total cost of contract performance with the total cost of in-house performance to determine a tentative cost-comparison decision.

On June 15, 2001, DFAS announced the tentative decision to award the contract to ACS Government Services Inc. The American Federation of Government Employees Locals 2040 and 3283 filed an appeal. As a result, the Administrative Appeal Authority corrected the in-house cost estimate by reducing the operational personnel costs for transition by \$16 million. The cost comparison reflected a total adjusted cost of contract performance of \$364.7 million compared to a total cost of in-house performance of \$366.6 million, representing a difference of \$1.9 million in favor of contract performance. Therefore, the Administrative Appeal Authority issued its final decision on



August 6, 2001, stating there was insufficient evidence to change the tentative decision. In September 2001, DFAS awarded the contract to ACS Government Services Inc.<sup>1</sup> The performance period of the contract was a 4-month transition-in period, 10 1-year options, and a 6-month transition-out period. The transition-in period began on September 28, 2001, was completed on January 27, 2002, and the contractor began the first option year on January 28, 2002.

**Congressional Inquiries.** On August 14, 2001, Congressman Kucinich and three members of Congress from Ohio sent letters to the Comptroller General, the Director of DFAS, and the Deputy Inspector General (IG) of the Department of Defense. The letters urged DFAS to suspend any activity aimed at completing a contract for the military retired and annuitant pay functions and requested the Comptroller General and the DOD Office of the Inspector General (OIG) to investigate the cost-comparison and appeal processes. The letters identified perceived flaws that may have marred the cost-comparison process. The issues raised included the appointment of an administrative appeal authority, the extension of the performance period from 5 to 10 years, the costing of the Directorate of Continuing Government Activity, and the ability of the contractor to retain in-house technical support staff.

On August 21, 2001, the DOD OIG agreed to examine the issues raised. On September 7, 2001, the Director, DFAS, disagreed with the assertions of error or impropriety that were in the congressional request and stated that he believed it was his obligation to move forward. On November 14, 2001, the Deputy IG stated that a fact-finding review of each issue did not indicate that OMB Circular No. A-76 was circumvented; however, provisions concerning performance periods for cost comparisons were ambiguous and subject to interpretation. On November 15, 2001, the Deputy IG sent a memorandum to the Under Secretary of Defense for Acquisition, Technology, and Logistics recommending additional guidance on the issue of whether extending the performance period beyond 5 years creates a known cost advantage for the competing contractor.

On December 7, 2001, after a meeting with staff from the DOD OIG, staff from Congressman Kucinich's office sent a letter and requested that three additional issues be reviewed:

- whether the Government's in-house cost estimate showed \$15 million in savings over the contractor's cost proposal during the first 5 years of performance,
- whether an economic price adjustment clause was included in the contract, and
- whether DFAS had more than \$70 million in unfinanced requirements for the military retired and annuitant pay functions.

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<sup>1</sup> On November 25, 2003, Lockheed Martin acquired the Federal Government information technology businesses of ACS. On May 24, 2004, DFAS modified the contract to change the contractor's name to Lockheed Martin Government Services, Inc.

**DOD IG Audit.** In response to the congressional request, we announced an audit of the military retired and annuitant pay functions public-private competition in January 2002. DOD IG Report No. D-2003-056, “Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions,” March 21, 2003, addressed the issues in the congressional request and identified additional issues.

**Economic Price Adjustment Determination Error.** The audit found an error in the DFAS military retired and annuitant pay functions cost comparison with respect to the determination of the personnel positions subject to an economic price adjustment. Specifically, in-house personnel costs for 426 of the 503 positions were incorrectly adjusted for inflation for the entire performance period instead of only the first year. The most efficient organization development team, DFAS management, and the independent review officer (DOD OIG) did not detect the error, and the competition was awarded to the contractor based on a savings of \$1.9 million (\$366.6 million minus \$364.7 million). However, had the error been identified prior to award, the Government’s in-house cost estimate would have been reduced by \$31.8 million. The correct economic price adjustment determination may have changed the outcome of the cost-comparison decision and retained the military retired and annuitant pay functions in-house. The report recommended that the Director, DFAS, determine a specific course of action for the military retired and annuitant pay functions contract, to include a determination of why a re-competition should not be held.

**Policy on Overhead Costs.** The audit found that the DFAS in-house cost estimate included \$33.7 million of “operations and general and administrative” overhead costs that were not reduced or otherwise affected by the conversion from in-house to contract performance. DFAS followed the procedures in the OMB Circular No. A-76 Revised Supplemental Handbook and was required to use the standard 12 percent cost factor for overhead costs because DOD did not develop and submit to OMB for approval an accurate overhead cost factor for DOD. However, the overhead costs were not reduced or otherwise affected and continued to be a DFAS cost. Using the mandatory overhead cost factor affected the results of the cost comparison because reducing the overhead costs would have lowered the Government’s in-house cost estimate.

**Contract Performance Requirements.** The audit also found that the DFAS contract for the military retired and annuitant pay functions had inadequate performance standards. The contract performance requirements were reviewed further during this audit; therefore, see the Audit Results section for a more detailed discussion of the prior issue with the contract performance requirements.

**Management Actions Taken and Congressional Request.** In response to the DOD IG recommendation concerning the economic price adjustment error, the Office of the Deputy Under Secretary of Defense (Installations and Environment) tasked the Center for Naval Analyses (CNA) on June 9, 2003, to provide an analysis of options DFAS could pursue for the military retired and annuitant pay functions. In September 2003, CNA issued its report and concluded that the “preponderance of evidence,” including an estimated \$42 million cost savings, favored retaining the existing contract as long as cost

continued to be reasonable and the performance was satisfactory. The CNA analyzed four options: retain the existing contract, return the pay functions to in-house performance without another public-private competition, conduct a new public-private competition, and conduct a private-private competition.

On November 20, 2003, after reviewing the CNA report, Congressman Kucinich requested that the DOD OIG evaluate the following two aspects of the analysis:

- review the \$42 million cost saving estimate associated with retaining the existing contract until the end of the 10-year performance period and
- explain the difference between the summary performance data and the random sample performance data used by the CNA to evaluate contractor performance and evaluate the appropriateness of CNA's presentation of the data.

**DOD IG Analysis of DFAS Sourcing Options.** DOD IG Report No. D-2004-088, "Analysis of the Defense Finance and Accounting Service Military Retired and Annuitant Pay Sourcing Options," June 16, 2004, disagreed with the \$42 million that the CNA estimated was a fair representation of the cost savings of the option to retain the existing contract compared with the option to return to in-house performance because of the methodology used. Specifically, the report discussed the following issues with the methodology used by CNA.

- CNA applied a partial cost reduction to the "return to in-house performance" option and a full cost reduction to the "retain the existing contract" option for the systems work that did not materialize as anticipated in the solicitation.
- CNA did not include a reduction of contract administration cost for the "return to in-house performance" option.

As a result, the DOD IG believed that showing the estimated cost savings as a range of \$11.2 million to \$41.5 million was a more fair presentation. Given that the performance of the contractor could not be evaluated on all contractual performance requirements, the DOD IG also disagreed with the CNA report that overall performance of the contractor could be evaluated.

In addition, CNA did not use equivalent scales when graphically presenting similar performance data. To illustrate the percentage of new accounts established within 30 days, CNA used a line graph with a scale of 93 to 100 to show prior Government performance and a bar graph with a scale 0 to 100 to show contractor performance. Contractor performance should be shown on graphs of similar type and scale to those used to show prior Government performance.

**Congressional Hearing and Request.** On July 16, 2008, the House Subcommittee on Domestic Policy, Committee on Oversight and Government Reform held a hearing on "Examining Contractor Performance and Government Management of Retroactive Pay for Retired Veterans With Disabilities," during which Congressman Kucinich verbally

requested the acting DOD IG to audit aspects of the DFAS contract. On July 21, 2008, Congressman Kucinich requested that the acting DoD IG audit aspects of contractor performance and Government management of work performed by the contractor for the DFAS military retired and annuitant pay functions. Specifically, he requested the DOD IG to review the following:

- contractor performance and contract costs for military retired and annuitant pay functions, including the Department of Veterans Affairs (DVA) retroactive entitlement program;
- contractor staffing for firm-fixed-price work, time and materials work (or other cost-reimbursable work), and any instance when Government staff were used to supplement contractor resources; and
- policies and procedures for voucher prepayment examination of contract payments for military retired and annuitant pay, including the DVA retroactive entitlement payments.

See Appendix B for the congressional request. On August 13, 2008, the DOD IG announced an audit in response to the request from Congressman Kucinich.

## **Defense Finance and Accounting Service Actions Taken During The Audit**

On December 22, 2008, DFAS completed a business case analysis evaluating the future sourcing options for the military retired and annuitant pay functions. The business case analysis considered three options: contractor support (status quo), Government in-house operation, or a hybrid option combining contractor and Government support. The analysis was based on four criteria: customer service, flexibility/risk, cost, and complexity of transition. The analysis recommended the option of a return to the Government in-house operation.

On April 20, 2009, DFAS announced that in early 2010, it would transition the military retired and annuitant pay functions to a Government operation performed by DOD civilians. The business case analysis showed that using DOD civilians would result in estimated savings between \$22.2 million and \$25.1 million over the next 10 years, provide improved flexibility, and reduce risks to operations. The DFAS Director stated that Government performance will allow DFAS to sustain and potentially improve service delivery and customer satisfaction.

## **Review of Internal Controls**

Because of the DFAS decision to in-source the retired military and annuitant pay functions, we did not complete our review of the internal controls and do not offer an opinion about the effectiveness of internal controls as it relates to the audit objectives.

# Audit Results

As a result of DFAS actions taken during the audit to return the military retired and annuitant pay functions to a Government operation, we did not fully complete audit fieldwork to evaluate the contract. However, completed audit fieldwork identified issues with monitoring contractor performance, call center customer service, and reviews of DVA Combat-Related Special Compensation and Concurrent Retired Disability Payment retroactive payments.

## Contractor Performance

DOD IG Report No. D-2003-056 states that the DFAS contract for military retired and annuitant pay functions had inadequate standards in the performance requirements summary for 7 of the 10 contract performance requirements. Four of the 10 requirements were identified as critical, meaning a penalty would be charged for failing to meet established quality levels. The standards were inadequate because there was no correlation between the contract requirements and the contractor's responsibilities for five performance requirements and the lack of measurability for two performance requirements. The report recommended that the Director, DFAS, rewrite the performance requirements to include all contractor responsibilities and methods to measure performance. The Director, DFAS, agreed with the recommendation and on April 1, 2004, DFAS modified the contract replacing the 10 performance requirements with 15 new performance requirements.

During the current review, we found that while the original standards combined retirees and annuitants in the same standard, the new standards divided retired and annuitant accounts into separate standards. The new standards address both accuracy and timeliness, while the original standards only addressed timeliness. Of the 15 performance requirements, 7 were identified as critical, meaning that a penalty would be charged for failing to meet established quality levels.

**Contract Performance Monitoring.** The DFAS Continuing Government Activity (CGA)<sup>2</sup> did not adequately monitor contractor performance for 6 of the 7 critical performance standards on its \$346 million (10-year) services contract with Lockheed Martin for the military retired and annuitant pay functions. The DFAS CGA has not effectively monitored performance because DFAS and Lockheed Martin disagreed on how to measure performance for the standards; DFAS experienced significant personnel turnover in key management and oversight positions; and the implementation of the DVA retroactive payment program caused the reallocation of CGA resources, impacting their ability to adequately monitor performance. As a result, since 2006, DFAS has relied primarily on Lockheed Martin's self-assessments to determine whether the acceptable quality levels were achieved.

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<sup>2</sup> The DFAS CGA was established to oversee the quality of work provided by the contractor and was responsible for conducting monthly evaluations.

**Deductions for Unsatisfactory Performance.** DFAS also has not held Lockheed Martin accountable for not performing to contract standards. By not enforcing deductions and appropriately addressing unsatisfactory performance, DFAS did not incentivize Lockheed Martin to improve performance, and DFAS essentially accepted performance below contracted levels.

We calculate that performance deductions totaling \$844,686 should have been taken for unsatisfactory performance from July 2004 through January 2009. However, DFAS took only \$297,450 in deductions over that time (DFAS assessed \$431,022 in deductions but later reimbursed \$133,572). As a result, we calculate that performance deductions totaling \$547,236 for unsatisfactory performance were not enforced by DFAS (see Table 1). The majority of the \$547,236 relates to deductions not taken for performance standard 4, “maintain existing military retired and annuitant pay accounts timely.”

<b>Table 1. Deductions for Unsatisfactory Performance</b>			
<b><u>Performance Period</u></b>	<b><u>Lockheed Martin/ DFAS Deductions</u></b>	<b><u>IG-calculated Deductions</u></b>	<b><u>Difference</u></b>
July 2004 - November 2005	\$ 275,651	\$ 306,967	\$ 31,316
December 2005 - January 2008	6,202	388,082	381,880
February 2008 - January 2009	149,169	149,637	468
DFAS Reimbursement (Standard 4)	(133,572)	0	133,572
Subtotal February 2008 – January 2009	\$ 15,597	149,637	134,040
<b>Total</b>	<b>\$297,450</b>	<b>\$844,686</b>	<b>\$547,236</b>

Lockheed Martin calculated the deduction amounts and reduced its monthly invoice for failing to meet performance standards. However, the calculations made were not always based on the fixed-price contract payment as the contract required. Therefore, our calculations of deduction amounts differed.

Deductions totaling \$275,651 from July 2004 through November 2005 were assessed for unsatisfactory performance on performance standards 2, 4, 5, and 6. However, the information we were provided was not sufficient to determine the total amount assessed for each performance standard. Based on the performance and limited cost information provided by DFAS for this period, we calculate that deductions should have totaled \$306,967 and an additional \$31,316 should have been collected from Lockheed Martin.

From December 2005 through January 2008, deductions totaling \$6,202 were assessed for unsatisfactory performance that included not meeting standards 1 (November 2007) and 6 (July 2007) in only one instance. However, we calculated that deductions totaling \$388,082 should have been assessed during that time period. Again, the primary difference (\$284,505 of \$388,082) in our calculations is the deductions that relate to



performance standard 4. According to CGA staff, DFAS and Lockheed Martin disagree on how to measure the performance for performance standard 4 in terms of “transactions” or “work items.” Regardless of which method was used to measure performance, Lockheed Martin consistently did not meet contract performance levels, with the exception of May 2005.

Performance standard 4 was consistently not met from December 2005 until June 2006, but DFAS did not assess any deductions. We calculate that deductions of \$76,281 are due for unsatisfactory performance during that time period. Then, from July 2006 through January 2008 (19 months), DFAS stopped monitoring contractor performance on this standard because the contracting officer decided that there was not a defined requirement on how to monitor performance. According to CGA staff, in August 2008 (almost 3 years since problems surfaced), the CGA Director<sup>3</sup> also decided not to pursue deductions for the time period not monitored that we calculate amount to \$208,223.

In February 2008, Lockheed Martin and DFAS resumed assessing deductions for unsatisfactory performance on performance standard 4 and continued to assess deductions through January 2009. However, DFAS subsequently reimbursed these deductions, totaling \$133,572, on the March 31, 2009, invoice to Lockheed Martin because the contracting officer offered a reimbursement to Lockheed Martin during negotiations to finalize the agreement on how this standard should be monitored. We find the performance of the two contracting officers and the CGA Director to be unacceptable given that this matter still remains unresolved 3½ years after problems surfaced. In addition, we believe it was unacceptable to make agreements that did not enforce performance deductions due from Lockheed Martin for unsatisfactory performance on this critical standard. The Director, DFAS, needs to review the performance and decisionmaking of the contracting officers as well as the decisionmaking and objectivity of the CGA Director and take appropriate action.

The Federal Acquisition Regulation subpart 33.210, “contracting officer’s authority,” authorizes the contracting officer “to decide or resolve all claims arising under or relating to a contract . . .” Although DFAS had a clear contractual right to collect these performance deductions, the agreements and decisions made by the contracting officers and the CGA Director create doubt as to whether DFAS could obtain the performance deductions from Lockheed Martin. The Director, DFAS, needs to exhaust all contractual remedies and expeditiously pursue a refund of \$547,236 plus interest from Lockheed Martin for the performance deductions due for unsatisfactory performance.

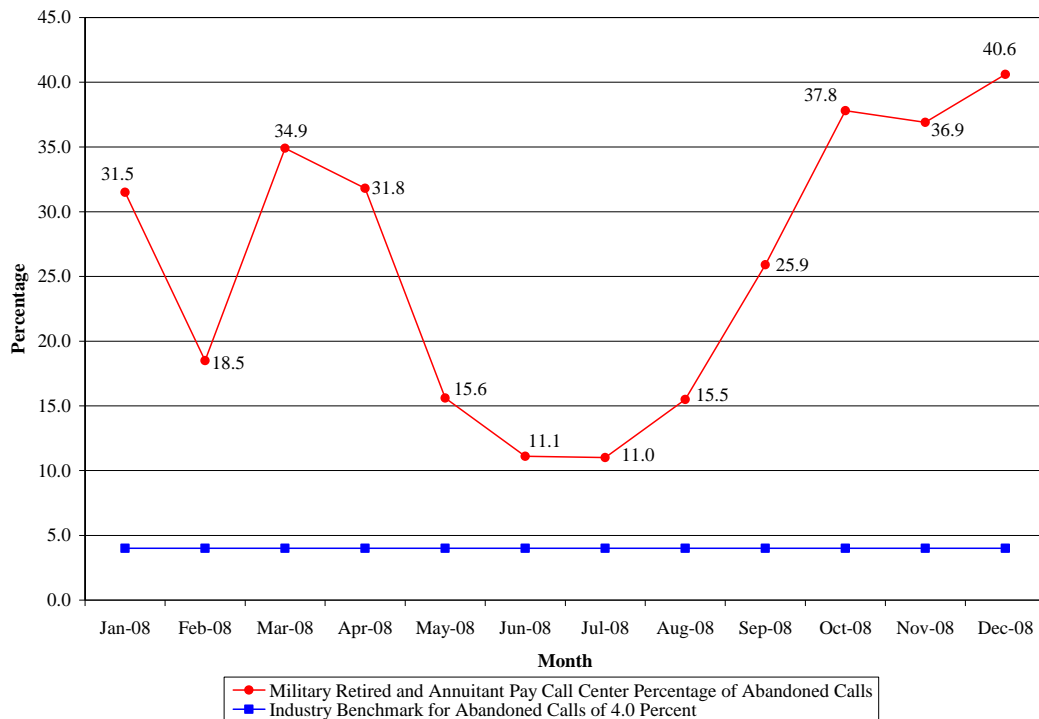
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<sup>3</sup> The CGA Director was employed by DFAS prior to the function being contracted out in 2001. He was then hired by the contractor as a program manager/primary contractor representative when the function transitioned to contractor support. He served in that role through the summer of 2004 and then worked for the contractor on other projects until May or June of 2007. In 2007, he was then re-hired by DFAS to serve as the CGA Director, a role he served until October 2008. He then worked as a special assistant to the Director, DFAS Cleveland, to develop the sourcing option business case. He still receives a monthly pension of \$513.95 from Lockheed Martin for his prior service. A DFAS Assistant General Counsel advised the agency of a potential financial interest issue for this individual. According to the Chief of Staff and the Director of Finance, DFAS Cleveland, this issue was discussed and determined not to be significant.

## Call Center Customer Service

The call center for military retired and annuitant pay functions operated by Lockheed Martin was providing service to DFAS callers that was far below industry standards. Specifically, for 2008, the call center average monthly call abandonment rates<sup>4</sup> ranged from 11.0 to 40.6 percent compared to an industry standard<sup>5</sup> of 4.0 percent, as shown in Figure 1.

**Figure 1. Military Retired and Annuitant Pay Center Abandoned Calls**



**Renegotiation of Performance Standards.** The original performance standards for customer service required the contractor to answer 80 percent of the calls within 20 seconds and to resolve pay problems within 30 calendar days of the notification. Also, there was no penalty for failing to meet these standards. DOD IG Report No. D-2003-056 found that these performance requirements were not evaluated against the established standards because DFAS did not have a system in place to measure how quickly a call was answered. The report recommended that the Director, DFAS, rewrite the performance standards and change the standards for customer service to critical, meaning that a penalty would be charged for failing to meet established quality levels.

The Director, DFAS, agreed with the recommendation and in May 2003, began renegotiating all performance standards with the contractor. During the negotiations, the contractor recommended a tiered standard for customer service based on the volume of

<sup>4</sup> Call abandonment rate is the percent of callers who hang up before talking to a service representative.

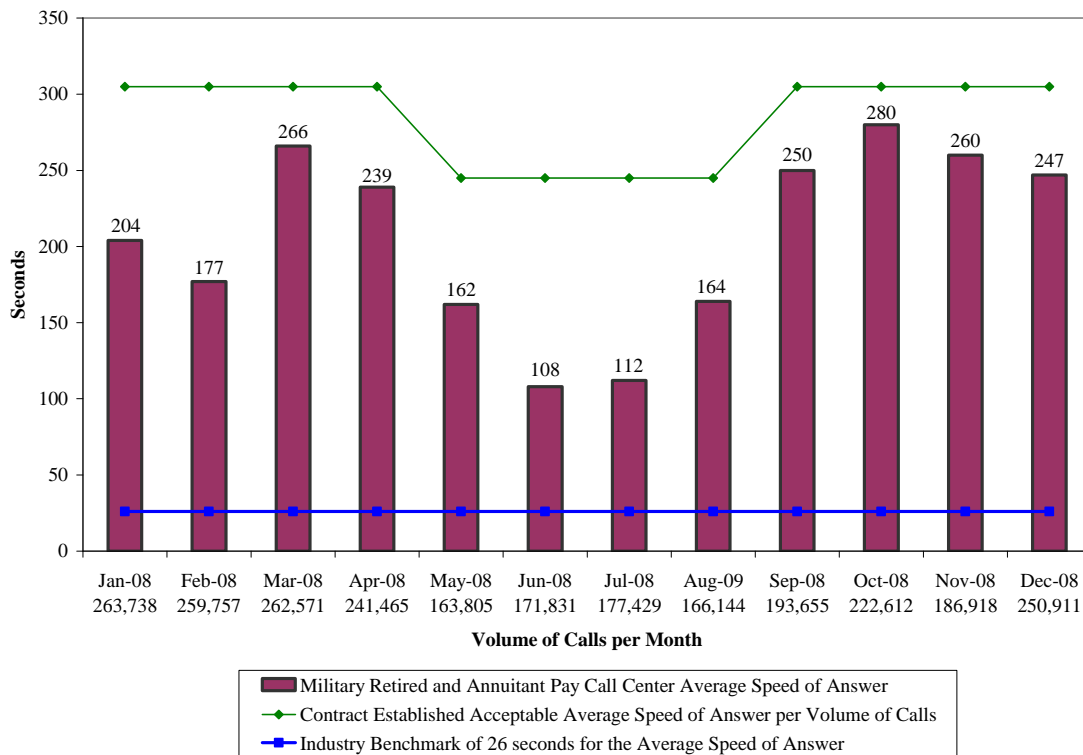
<sup>5</sup> The industry standards were taken from the "Defense Finance and Accounting Service Retired and Annuitant Pay Call Center Benchmark Study," March 2003 conducted by Deloitte & Touche.

calls received. DFAS accepted the tiered standard and included it in the April 1, 2004, modification as the new call center performance standard, focusing the standard on the average speed of answer. Table 2 shows the revised performance standard. However, DFAS did not implement the previous DOD IG recommendation because it did not provide a penalty for failing to meet the performance standard.

<b>Table 2. Average Speed of Answer</b>		
<b><u>Volume of Total Monthly Calls</u></b>	<b><u>Average Speed of Answer (Seconds)</u></b>	<b><u>Approximate Minutes</u></b>
Up to 90,000	35-45	0.75
90,001-120,000	55-60	1.0
120,001-150,000	145-155	2.5
150,001-180,000	235-245	4.0
More than 180,000	295-305	5.0

**Call Center Performance.** Figure 2 shows that while Lockheed Martin’s call center performance met the performance standard in 2008, the time to answer calls ranged from 108 (1 minute, 48 seconds) to 280 seconds (4 minutes, 40 seconds) compared to an industry standard of 26 seconds. Further, with this tiered average speed of answer performance standard, it seems unlikely that the contractor would ever fail to meet the performance standard ranging from 4 to 5 minutes based on call volume.

**Figure 2. Military Retired and Annuitant Pay Call Center Average Speed of Answer Compared with Contract and Industry Standards**



The unsatisfactory performance of the military retired and annuitant pay call center occurred because the renegotiated call center performance standard actually reduced requirements and defined satisfactory performance well below industry standards, and DFAS did not establish penalties for failing to provide an acceptable level of performance. As a result, DFAS callers with questions about military retired and annuitant pay functions have not received satisfactory service since the functions were contracted to Lockheed Martin. Further, DFAS did not obtain the expected service for customers when it contracted the military retired and annuitant pay functions in 2001. Because DFAS will in-source the functions in early 2010, we did not make a recommendation relating to call center performance.

## **Veterans Affairs Retroactive Payments**

In September 2006, DVA identified more than 133,000 recipients of Combat-Related Special Compensation or Concurrent Retired Disability Payment potentially eligible for additional retroactive compensation. Since then, DFAS, in coordination with the DVA, has processed all of the original cases as of June 8, 2008. Throughout the project DVA identified additional retirees that were prospectively eligible for retroactive payments. The agency also resubmitted accounts, from the original 133,000, for potential supplementary entitlements. Those accounts, classified as “new and returning,” were processed as of June 29, 2008. Those people identified with potential eligibility for retroactive payment after January 2008, were placed in a category referred to as “ongoing.” The ongoing category documents the most recently received new and returning DVA cases. CGA personnel stated that there is an average of 3,500 new accounts established each month; in December 2008, there were 5,000 new accounts. In May 2009, DFAS officials stated that as many as 39,000 military retirees were left out of the original recipients to receive retroactive payments, but DFAS expected to process these accounts by July 15, 2009. As of August 2009, DFAS officials stated that the processing of these accounts had not been completed because the number of military retirees left out the original recipients group had grown to 75,000. DFAS officials expected all accounts to be processed by the end of 2009.

**Calculation Process.** The audit team observed a Lockheed Martin technician demonstration of the process used to calculate a military retiree’s retroactive payment. The process is manually intensive and is very complex. The technician had to review and retrieve data from 10 to 20 screens from several different data sources and manually input the information into a spreadsheet. The Lockheed Martin DVA Retroactive Pay program director stated that a technician completes an average of 2.5 payment calculations a day. With the calculation being mostly a manual input process, a typographical error is highly possible leading to incorrect payments. In addition, the complexity of the process means that most retirees are unable to determine if the payments they receive are accurate.

**Payroll Categories and Review Method.** The retroactive payrolls were separated into five categories based on the payment amount and who was responsible for making the retroactive payment. Table 3 lists the categories of payrolls and the associated review method.

<b>Table 3. Payroll Categories and Associated Review Method</b>	
<b><u>Payrolls</u></b>	<b><u>Review Method</u></b>
DFAS payment > \$2,500	All
DFAS payment < \$2,500	Sample*
DVA payment only	Sample*
Zero Balance Due	Sample*
Negative Balance Due	Sample*
*Sampling plan created by DFAS statisticians, selection of accounts by "Ez-Quant" sampling method.	

**Pre-Payment Review Processes.** The DFAS CGA did not have any standard operating procedures to conduct pre-payment reviews of DVA retroactive payrolls until March 20, 2009, and Lockheed Martin review procedures had been updated several times, the most recent revision was effective November 24, 2008. DFAS also considers it acceptable for payrolls to have a 97 percent or greater accuracy rating and certifies and processes payrolls achieving this standard. As a result, payrolls were processed with varying degrees of review increasing the likelihood that erroneous payments were made. Because DFAS will in-source the functions in early 2010, we did not make a recommendation relating to reviews of retroactive payrolls.

## **Other Matter of Interest – Staffing**

Congressman Kucinich requested that the DOD IG review the staffing of the contract, including any instance when the Government supplemented the contractor. In its technical proposal, ACS proposed to have 451 employees on board at the end of transition and to have staffing down to 255 employees by the eighth year of the contract. ACS proposed technology improvements to accomplish the staff reductions. In September 2006, prior to the DVA retroactive processing, Lockheed Martin had reduced staffing to 397 employees. However, due to the new DVA workload, staff reductions did not occur as planned. As of September 2008, Lockheed Martin had 611 staff assigned to military retired and annuitant pay. According to the Lockheed Martin organizational chart, DVA retroactive processing consisted of 193 staff, including temporary employees.

According to the Director, Finance Systems Support for DFAS Cleveland, DFAS staff, consisting of seasonal employees hired by contract, provided supplemental support answering calls made to the Lockheed Martin DVA retroactive call center from March through June 2008. DFAS also assisted with verifying data in award letters. DFAS helped Lockheed Martin so staff could be reassigned to assist with the backlog of DVA

retroactive payroll processing. DFAS incurred costs of \$168,021 for this work. The Director, DFAS, needs to determine whether to seek reimbursement for the \$168,021 spent supplementing the Lockheed Martin call center.

## **Recommendations, Management Comments, and Our Response**

### **1. We recommend that the Director, Defense Financial and Accounting Service:**

**a. Review the performance and decisionmaking of the contracting officers as well as the decisionmaking and objectivity of the Continuing Government Activity Director and take appropriate action.**

### ***DFAS Comments***

The Director, DFAS Cleveland, disagreed stating that the performance and decisionmaking of the contracting officers and the decisionmaking and objectivity of the Continuing Government Activity Director were reviewed for the issues identified in the report, and DFAS concluded that actions were appropriate and there was no lack of objectivity. She further stated that the DFAS Office of General Counsel, as the DFAS ethics office, determined that there was no financial conflict of interest and that the DOD Standards of Conduct Office agreed with the determination.

### ***Our Response***

Although the Director, DFAS Cleveland, disagreed with the recommendation, DFAS did review the performance of the contracting officers and the objectivity of the Continuing Government Activity Director. Therefore, we consider the comments responsive. However, we question how the failure to resolve disagreements with the contractor for more than 3 years as well as the failure to enforce the contract penalties for unsatisfactory performance could be deemed appropriate performance for the contracting officers. We believe that their performance was not in the best interests of DOD and the taxpayers.

The DFAS Assistant General Counsel who authored the legal opinion recommended that management consider whether an appearance of partiality exists based on the individual's employment with Lockheed Martin within the past year and his prospective Lockheed Martin pension. Pursuant to 5 Code of Federal Regulations section 2635.502 (2009), "Personal and Business Relationships," the determination is the responsibility of the agency designee and not the attorney. The DFAS Cleveland Chief of Staff and the Director of Finance stated that the issue was discussed but the discussion was not documented. We advise that future determinations be documented and maintained by DFAS management. No further comments are required.



**b. Exhaust all contractual remedies and expeditiously pursue a refund of \$547,236 plus interest from Lockheed Martin for the performance deductions due for unsatisfactory performance.**

### ***DFAS Comments***

The Director, DFAS Cleveland, disagreed stating that the Government does not have a right to these deductions. The Director stated that the contractual performance standard for performance standard 4 and its implementation was not agreed upon by the Government and the contractor. Further she stated that although numerous attempts were made, there was never a bi-lateral agreement on the measures incorporated through written contract modifications.

### ***Our Response***

The DFAS comments are not responsive. Contract modification P00026 (effective April 2004) implemented the new performance standards for the contract to include performance standard 4. The modification was signed by both the contractor's contracts manager and the DFAS contracting officer. There were no subsequent modifications to that agreement relating to performance standard 4. In addition, Lockheed Martin reported on its self-assessments that it consistently failed to meet the required performance level and assessed deductions on invoices for failing to perform. Clearly, Lockheed Martin believed it was required to perform based on the contract modification and acted appropriately. We question the DFAS conclusion that it did not and does not have a contractual right to these performance deductions. As discussed in the report, DFAS had a contractual right and needs to expeditiously pursue payment for unsatisfactory performance. Given these facts, we request that DFAS reconsider its conclusion and provide a response to the final report.

**c. Determine whether to seek reimbursement for the \$168,021 spent supplementing the Lockheed Martin call center.**

### ***DFAS Comments***

The Director, DFAS Cleveland, disagreed stating that DFAS Cleveland operational leadership directed Lockheed Martin to move a number of military retired and annuitant pay call center employees to work on the DVA retroactive pay program and after completion of the project, Lockheed Martin offered a *credit* of \$46,945 representing the cost avoidance that Lockheed Martin had by moving employees. Further, she stated that the assertion of the audit report and the original position DFAS Cleveland leadership was that the costs to the Government should be the level of compensation sought; however, the Government manned the project well above the contractually mandated level of performance. She stated that based on the tenets of good contract management, proper use of the contracting officer authority, and consultation with the Office of General Counsel; the Government is entitled to reimbursement only at the level that keeps all "parties whole" in a fair and reasonable *settlement*, and that is what the contractor's reimbursement represented.

## ***Our Response***

The DFAS comments are not responsive. The Director, DFAS Cleveland, disagreed with the recommendation, stating that Lockheed Martin offered DFAS a *credit* of \$46,945 representing the cost avoidance for DFAS performance of the work. Additionally, she stated that Lockheed Martin's reimbursement represented a fair and reasonable *settlement*. Whether the offer of \$46,945 constituted a *credit* for cost avoidance or a *settlement* for inadequate performance depends on the facts and circumstances that led to Lockheed Martin's offer. It is unclear whether DFAS accepted the offer of *credit* as savings passed to the Government due to actions taken to reduce performance costs or as part of a *settlement* agreement to reimburse the Government for deficient performance which could provide grounds for termination of the contract. DFAS did not respond to multiple requests for supporting documentation. Further, we do not believe that this offer would be considered fair, when the costs incurred were three times greater than the reimbursement. We request that DFAS provide a response to the final report clarifying whether the reimbursement was a *credit* for cost avoidance or a *settlement* for unsatisfactory performance and provide supporting documentation, including the terms and conditions, for acceptance of the reimbursement, if agreed to, with Lockheed Martin.

## **Appendix A. Scope and Methodology**

We conducted this performance audit from September 2008 through August 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our results and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our results and conclusions based on our audit objectives. We performed the audit in response to a request from Congressman Kucinich to review the DFAS contract for retired military and annuitant pay functions contract. On April 20, 2009, DFAS announced its decision to in-source the military retired and annuitant pay functions. In May 2009, after a delay of 4 months from our original request, DFAS provided, and we reviewed, a copy of the DFAS “Business Case Analysis of Retired & Annuitant Pay,” dated December 22, 2008. Because the DFAS decision to in-source will significantly impact the current operations of the military retired and annuitant pay functions, we concluded our review. Accordingly, our audit scope was limited and we did not perform a full review of DVA retroactive payrolls and processes. We also did not complete our review of the contracting issues identified.

We met with the DFAS Cleveland Director, Deputy Director, and Director of Finance. We interviewed the contracting officer, contracting officer’s representative, and DFAS CGA personnel to obtain information about the government oversight of the retired military and annuitant pay functions contract. We reviewed the revised performance standards that took effect in July 2004. We reviewed Lockheed Martin self-assessments for 2006 through 2008. We obtained and reviewed contractor invoices from February 2006 through January 2009 for deductions taken for not meeting acceptable quality levels. For deductions taken prior to February 2006, we reviewed limited cost information provided by DFAS.

We interviewed the Director, Finance Systems Support and obtained 2008 monthly averages for the Lockheed Martin operated Retired and Annuitant Pay call center and DFAS operated call centers. Specifically, we obtained average speed of answer and abandoned calls statistics. We reviewed the, “Defense Finance and Accounting Service Retired and Annuitant Pay Call Center Benchmark Study,” March 2003.

We met with Lockheed Martin DVA retroactive entitlement program personnel to obtain a demonstration and understanding of the DVA retroactive payment process. We reviewed the standard operation procedures for the DVA retroactive payment process and the prepayment review processes conducted by Lockheed Martin and DFAS. We obtained and reviewed Lockheed Martin organization charts.

### **Use of Computer-Processed Data**

We did not use computer-processed data to perform this audit.

## **Prior Coverage**

The DOD IG has previously issued two reports discussing the DFAS retired military and annuitant pay functions contract. Unrestricted DOD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

### ***DOD IG***

DOD IG Report No. D-2004-088, “Analysis of the Defense Finance and Accounting Service Military Retired and Annuitant Pay Sourcing Options,” June 16, 2004

DOD IG Report No. D-2003-056, “Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions,” March 21, 2003

# Appendix B. Congressional Request

HENRY A. WAXMAN, CALIFORNIA  
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ONE HUNDRED TENTH CONGRESS

## Congress of the United States House of Representatives

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July 21, 2008

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Mr. Gordon Heddell  
Acting Inspector General  
U. S. Department of Defense Office of Inspector General  
400 Army Navy Drive  
Arlington, Virginia 22202

Dear Mr. Heddell:

This letter is a formal request for an audit of a number of aspects of contractor performance and government management of work performed by contractor under contracts let by the Defense Finance and Accounting Service (DFAS). It follows up on a number of verbal requests I made at last week's hearing, which was entitled "Examining Contractor Performance and Government Management of Retroactive Retired Pay for Veterans with Disabilities." At the hearing, you agreed to those requests.

I hereby request that you review:

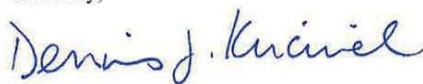
- Contractor performance and contract costs for Military Retired and Annuitant Pay Functions, including VA Retro entitlement payments;
- Contractor staffing for firm-fixed-price work, time and materials work (or other cost-reimbursable work), and any instances where government staff were used to supplement contractor resources;
- Policies and procedures for voucher prepayment examination of contract payments for Military Retired and Annuitant Pay, including VA Retro entitlement payments, and
- Any other issues discovered in the course of your audit.

As this audit is a high priority for the Subcommittee and future hearings on the subject are envisioned, I additionally request that you assign sufficient numbers of experienced staff to this audit to permit a thorough and expeditious effort by your office.

Mr. Gordon Heddell  
Acting Inspector General  
July 21, 2008  
Page 2

If you have any questions regarding this request, please contact Jaron Bourke, Staff Director,  
at (202) 225-6427.

Sincerely,

A handwritten signature in blue ink that reads "Dennis J. Kucinich". The signature is fluid and cursive, with the first name "Dennis" and last name "Kucinich" clearly legible.

Dennis J. Kucinich  
Chairman  
Domestic Policy Subcommittee

Enclosure

cc: Darrell Issa  
Ranking Minority Member



# Defense Finance and Accounting Service Comments



## DEFENSE FINANCE AND ACCOUNTING SERVICE

1240 EAST NINTH STREET  
CLEVELAND OHIO 44199

SEP 23 2009

DFAS-JBB/CL

MEMORANDUM FOR DIRECTOR, ACQUISITION AND CONTRACT MANAGEMENT,  
OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF  
DEFENSE

SUBJECT: Office of the Inspector General Draft Report, Project No. D2008-D000CH-0262.000,  
"Defense Finance and Accounting Service Contract for Military Retired and  
Annuitant Pay Functions," dated August 31, 2009

The Defense Finance and Accounting Service Cleveland is providing response to  
Recommendations 1.a, 1.b, and 1.c of the subject draft audit report in Attachment 1.

The point of contact is \_\_\_\_\_ can be reached at \_\_\_\_\_.

A handwritten signature in black ink, appearing to read "Martina J. Smith".

Martina J. Smith  
Director, DFAS Cleveland

Attachment:  
As stated

cc:  
DFAS-HIP/TN

**DFAS Comments to DoD IG Draft Report, Project No. D2008-D000CH-0262.000,  
“Defense Finance and Accounting Service Contract for Military Retired and  
Annuitant Pay Functions,” dated August 31, 2009.**

**Audit Results, Recommendations.**

**Recommendation 1.a.** We recommend that the Director, Defense Finance and Accounting Service review the performance and decision making of the contracting officers as well as decision making and objectivity of the Continuing Government Activity Director and take appropriate action.

**Management Comments.** Non-Concur. Performance and decision making of the contracting officers and the decision making and objectivity of the Continuing Government Activity Director were reviewed for the issues stated. The contracting officers' actions were appropriate and did not lack objectivity. The question of a potential financial conflict of interest on the part of the CGA Director was raised, researched and analyzed. It was determined by the DFAS Office of General Counsel, as the Agency's Designated Agency Ethics office, not to be a financial conflict of interest. This determination was concurred with by the DoD Standards of Conduct Office. Management of the CGA changed in September 2008 to an active duty Navy officer and the CGA will be disbanded in February 2010. Therefore, we feel no further action is required.

**Completion Date.** Not Applicable.

**Recommendation 1.b.** We recommend that the Director, Defense Finance and Accounting Service exhaust all contractual remedies and expeditiously pursue a refund of \$547,236 plus interest from Lockheed Martin for the performance deductions due for unsatisfactory performance.

**Management Comments.** Non-Concur. The government did not, and does not have a right to these deductions based on the following:

The contractual performance standard for J1 #4 and its implementation was not agreed to between the Government and the contractor from April 1, 2004, forward. Although numerous attempts were made, there was never a bi-lateral agreement on the measures incorporated via written contract modification. Therefore, the Government was not entitled to deductions.

**Completion Date.** Not Applicable.

**Recommendation 1.c.** We recommend that the Director, Defense Finance and Accounting Service determine whether to seek reimbursement for the \$168,021 spent supplementing the Lockheed Martin call center.

**DFAS Comments to DoD IG Draft Report, Project No. D2008-D000CH-0262.000,  
“Defense Finance and Accounting Service Contract for Military Retired and  
Annuitant Pay Functions,” dated August 31, 2009.**

**Management Comments.** Non-Concur. DFAS Cleveland Operational leadership directed Lockheed Martin (LM) to move a number of Retired and Annuitant Pay call center employees to work VA Retro. After completion of the project, LM offered a credit of \$46,945 representing the cost avoidance that LM had by moving the employees. The assertion of the draft audit report and the original position of Cleveland leadership was that the costs to the Government should be the level of compensation sought; however, the Government manned the project well above the contractually mandated level of performance. Based on the tenets of good contract management, proper use of Contracting Officer authority, and consultation with the Office of General Counsel, the Government is entitled to reimbursement only at the level that keeps all parties whole in a Fair and Reasonable settlement, and that is what the contractor's reimbursement represents based on the information provided by the parties in substantiation of their positions.

**Completion Date.** Not Applicable.



# Inspector General Department of Defense